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5 questions & answers on the TCJA’s 20% pass-through deduction

The Tax Cuts and Jobs Act added IRC §199A, which allows owners of pass-through entities—sole proprietorships, S corporations, LLCs and partnerships—to deduct 20% of their qualified business income on their 1040s. Congress’ intent was to level the playing field with regular, tax paying C corporations, since owners of pass-through entities pay taxes at the individual tax rates, which now outstrip the 21% corporate rate.

IRC §199A is a complicated provision, with some definite payroll implications. Earlier this month, the IRS released proposed regulations that are supposed to take care of some basics.

Here’s our take on the payroll-related provisions, in five not-so-frequently-asked questions. The IRS has its own FAQs.

Could an employer insist that employees become pass-through entities?

No. The regs recognize that you might be motivated to kick employees off the payroll and treat them as pass-through entities that contract to provide the same services they provided as employees. Under the regs, employers’ federal tax classification of employees is immaterial. If workers are employees under the traditional payroll rules, they remain employees, these regs notwithstanding.

Worse: If you do this, you will likely forfeit any penalty relief under Section 530 of the Revenue Act of 1978, and if you change your mind back, you’ve probably also forfeited the opportunity to participate in the IRS’ voluntary classification settlement program.

Likewise, could an employee turn herself into a pass-through entity and continue working for the same employer?

Similarly, employees who quit, become pass-through entities and return to their old jobs, are presumed to continue to be employees. *Key:* This presumption applies *only* for purposes of this deduction; it doesn’t apply to the broader issue of whether workers are employees or independent contractors.

What about businesses that elevate employees to partners or owners?

Under the regs, employees are presumed to continue to provide services as employees. But this is a rebuttable presumption. The burden is on employees to prove that they should be treated as other than employees. Employees may find that proof in company policies or employment contracts that establish the criteria for becoming an owner or partner.

How does the requirement that S corps’ pay shareholder-employees reasonable FICA-taxable salaries relate to this deduction?

S corp shareholder-employees may be motivated to classify more of their FICA-taxable income as distributions to pump up their qualified business income and, hence, their 20% deduction. The regs stress, however, that S corp shareholder-employees must still be paid a FICA-taxable salary.

Does the requirement to pay reasonable FICA-taxable salaries now extend to partners?

No. Under longstanding IRS rules, partners can never be employees, so they don’t go on the payroll and don’t need to be paid reasonable FICA-taxable salaries. However, the regs clarify that qualified business income doesn’t include guaranteed payments paid by a partnership to partners for services rendered with respect to the partnership’s trade or business.

7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002